No. 10289

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

LOMBARD TRUSTEES, LTD., a Trust, and CHARLES S. LOMBARD, BERTHA M. LOMBARD and NORMAN M. LOMBARD, Trustees thereof,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S OPENING BRIEF.

UPON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES.

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Record on Appeal.

This proceeding is to review a decision of the Tax Court of the United States, formerly called the "United States Board of Tax Appeals" and hereinafter called "Board". The record on appeal consists of an agreed statement of the case under rule 76 of the Rules of Civil Procedure, which statement is printed in full in the transcript of the record. The latter is herein referred to by the letter "T", and its pages by their numbers. The only previous opinion is the memorandum opinion of the Board, which, with the findings, is printed in full in the transcript. [T 53-73.]

Jurisdiction.

This appeal involves income and excess profits taxes for the year 1937 and is taken from a decision of the Board entered June 19, 1942. [T 74.] Petitioner's income tax return for 1937 was filed with the Collector of Internal Revenue at Los Angeles. The office of said Collector is within the Ninth Circuit. The case is brought to this Court by petition for review filed September 8, 1942 [T 75-77], under the provisions of Sections 1141-1142 of the Internal Revenue Code.

Questions Presented.

(a) Whether a trust of which the grantor and creator is the sole beneficiary may be an "association" taxable as a corporation;

(b) When a written declaration of trust is silent as to purpose or is consistent with different purposes, whether evidence of the purpose of the grantor in creating the trust is relevant.

Statement of the Case.

On November 3, 1935, at Redlands, California, Charles S. Lombard (hereinafter called "Dr. Lombard"), then aged 83 years, his wife (hereinafter called "Mrs. Lombard") and three of their children executed instruments hereinafter called "trust declaration" whereby the legal title of certain property theretofore owned by Dr. Lombard, was vested in Dr. Lombard, Mrs. Lombard and

Norman M. Lombard, as trustees of an express trust. Said three persons, as such trustees, are sometimes herein referred to as "petitioner", and sometimes as "trustees". Subsequently, Dr. Lombard caused the legal title of other property owned by him to be vested in said trustees. Dr. Lombard was the sole beneficiary under said trust and held the entire beneficial interest from the time of its creation on November 3, 1935, until March 14, 1937. On the last mentioned date, a part of the beneficial interest was transferred to and became vested in Dr. Lombard's wife and five of their children, and on February 25, 1938, another part of the beneficial interest was transferred to and became vested in three others of their children, so that from and after February 25, 1938, the beneficial interest was held by Dr. Lombard, Mrs. Lombard and eight of their children, three being of their marriage, four of Dr. Lombard's previous marriage, and one of Mrs. Lombard's previous marriage. [T 7-11.] The instrument resulting in the first change in the ownership of the beneficial interest was dated February 10, 1937. [T 40.]

The trustees filed a fiduciary return of income for the year of 1937. On June 15, 1940, respondent gave notice of a deficiency in 1937 taxes, stating and holding that petitioner was taxable as an association for the period February 10, 1937 to December 31, 1937, and that Dr. Lombard as grantor and creator of the trust was taxable for the income prior to February 10, 1937. Respondent apportioned the total income for 1937 on a daily basis to

February 10, 1937 between Dr. Lombard and petitioner and determined there was a deficiency in petitioner's taxes. [T 1, 2.]

The trustees petitioned the Board for a redetermination. The cause was heard at Los Angeles on June 10, 1941. At the hearing, respondent filed an amended answer alleging petitioner was an association taxable as a corporation during all of 1937. At such hearing the case was submitted upon said fiduciary return for 1937, a gift tax return of Dr. Lombard for 1935, and two written stipulations that have been incorporated in the record on appeal. [T. 2, 3.]

The Board determined petitioner was an association taxable as a corporation and that petitioner was such association during all of 1937. [T 73.]

ARGUMENT.

Assuming the Trust Was an Association Taxable as a Corporation During Some Part of 1937, It Did Not Become Such Until Others Became Associated With Dr. Lombard as Beneficiaries, and No Persons Became Associated With Dr. Lombard so as to Form Such Association Until March 14, 1937.

Dr. Lombard bought the trust declaration from a person engaged in real estate and insurance. It was a copyrighted, stereotyped form known as the "Hulbert Plan trust". [T 17, 18.] It was the identical, legal monstrosity that was considered by this Court in *Porter Property Trustees, Ltd. v. Commissioner,* where in an opinion rendered July 29, 1942, Porter Property Trustees, Ltd. was held to be an association taxable as a corporation. We have no quarrel with that decision.

At the time of the establishment of the trust on November 3, 1935, 600 "expectancy fractions" were registered in the name of Dr. Lombard. [T 10, p 8.] At a meeting of the trustees held March 14, 1937, they received an instrument dated February 10, 1937, signed by Dr. Lombard, entitled "request to vacate registration". [T 10, p 9.] This was a request to change the registration of the 600 "expectancy fractions" so as to show 350 in Dr. and Mrs. Lombard as joint tenants and 50 in each of five children. [T 40, 41.] On March 14, 1937, the trustees adopted a resolution [T 10] approving the request and instructing the Secretary to register the "expectancy fractions" pursuant to the request, the resolution concluding "hereby approving the registration as of the date of the Request, Feb. 10, 1937". [T 42.] The stipulation of

facts recited that "pursuant to the request and resolution said 600 'expectancy fractions' were, on March 14, 1937, registered on the records of the trustees in the manner provided in said request". [T 11, p 10.]

No case has been found or was called to the attention of the Board in which it was held or intimated that a trust of which the grantor and creator was the sole beneficiary constituted an association. On the contrary, every statement from the Supreme Court down establishes that at least two beneficiaries are essential to constitute an association. Further, while a trust may be an association whether it has one or several trustees, no court ever heretofore held or intimated that the plurality required to constitute an association might be satisfied by two or more trustees. The decision of the Board involves and, we respectfully allege, violates a most important legal principle.

The case also involves substantial taxes. It may not be disposed of by application of the principle *de minimis non curat lex.*

There have been two major freezes in Southern California affecting the citrus industry, one in 1913 and the other in January of 1937. During 1936 and thereafter, the trustees had title to a 46-acre orange grove at Redlands. On January 1, 1937, there was on this grove a matured navel crop. [T 13, 14.] It is evident this crop was saved during the freeze for, on February 23, 1937, the crop was sold on the trees for the fabulous price of $2.80 per hundred pounds, the buyer to pick and haul, with the picking to commence March 10, 1937 and be fully completed by April 10, 1937. No expenses were incurred or paid by the trustees after the sale of the crop on February 23, 1937. The trustees received for the crop $16,868.96 of

which $15,000 was received prior to March 14, 1937. [T 13-15.]

The entire amount received for this fruit represented income accrued prior to March 14, 1937. It is not impossible Dr. Lombard had ascertained that respondent deemed all income of the trust was to be returned by and taxed to him while he was the sole beneficiary, and, therefore, on March 14, 1937, he transferred a portion of the beneficial interest to Mrs. Lombard and the children, intending the gift and transfer to be retroactive to a date prior to the sale of the fruit (as he might lawfully do), but erroneously believed the income from the fruit would then be returnable by all of the beneficiaries. Such return was in fact made. [T 63.] If Dr. Lombard was liable to return and pay the tax on the 1936 income of the trustees (as he in fact was), he was also liable to return and pay the tax on all income of the trustees up to March 14, 1937, which included the $16,868.96 from the sale of the navel crop. He could not relieve himself of this liability by a gift of the income.

Assuming the trust became an association on March 14, 1937, the net income for the period March 14, 1937 to December 31, 1937 (excluding orange proceeds of $1,-868.96) amounted to $6,613.43 [T 13], and the tax at corporate rates was:

Normal tax $355.79 and undistributed profits tax $531.50, making a total of $887.29.

The Board determined the tax on petitioner to be:

Normal tax	$2,149.30
Surtax on undistributed profits	3,669.36
Excess profits tax	258.14
Total	$6,076.80

Therefore, the point under discussion involves federal taxes for 1937 amounting to $5,189.51. Nor is that all, for the Franchise Tax Commissioner of California is awaiting the decision in this case to determine whether there is a liability for franchise tax, and if so, whether that liability attached to income of the trust from November 3, 1935 on, or only on income after March 14, 1937.

Nor should it be thought a decision favorable to petitioner will result in the 1937 income escaping taxation. As noted, the entire income for 1937 was reported as taxable to Dr. Lombard, Mrs. Lombard and six children. [T 63.] . It is proper to assume that each included as a part of his income for 1937 the amount reported by the trustees as returnable by him. The time for filing refund claims expired three years after March 15, 1938. The decision of the Board was rendered after the time for filing refund claims had expired. Should it be held that petitioner was an association during all of 1937, then the 1937 income will have been taxed twice, one at rates applicable to individuals and again at corporate rates, including therein a very harsh undistributed profits tax alone amounting to $3,669.36. Should it be held that the trust became an association on March 14, 1937, only a part of the 1937 income will be doubly taxed. We are not asking for, nor do we expect, sympathy. At the same time, we do not expect anyone to assert, imply or think that the trustees have unclean hands and are not entitled to a decision solely on the facts and the law.

(Unless otherwise noted, all emphasis has been added by the writers.)

In the leading case of *Morrissey v. Commissioner*, 296 U. S. 344, the laws and decisions pertaining to the term "association" were extensively reviewed, and it was said:

> " 'Association' implies *associates*. It implies the entering into a *joint enterprise*, and, as the applicable regulation imports, an enterprise for the transaction of business."

In *Helvering v. Coleman-Gilbert Associates*, 296 U. S. 369, the same court declared:

> "A *few* persons, as well as many, may form an association to conduct a business for *their common* benefit."

In *Garfield Building Site Trust v. Commissioner* (1940), 115 Fed. (2d) 481, the following definition was given:

> "The term 'association' does not have in law the fixed meaning accorded to 'partnership' or 'corporation' but in its business sense is used to indicate a *collection of persons* who have united or joined together for some business purpose. It may be defined as a *body of persons* acting together without a charter but using the methods and forms of corporate bodies in the prosecution of some business enterprise for profit."

See also the numerous definitions of association in *Paul and Mertens Law of Federal Income Taxation*, Vol. 4, Sec. 35.10, 1934 ed.

From every definition and case, it is clear that two or more must be united or associated in a common purpose. In some instances the trust form is used to give effect to the purpose. Assume there was an association not in

trust form that functioned through a committee, or a board of managers. Such managing committee or board would not constitute the "associates" or the "few persons" or the "collection of persons" or the "body of persons" referred to in the foregoing definitions. Those beneficially interested (in most associations called "members") would be the "associates" or "few persons" or "collection of persons" or "body of persons". Those for whose benefit the enterprise is conducted are the "associates". In the case of an association in trust form, it is the beneficiaries of the trust or *cestuis que trustent* who are the associates. The trustee or trustees, if the association be in trust form, or the committee or board of managers, may or may not be beneficially interested as members.

The foregoing statements are distinctly recognized by the regulations which were the same in 1937 as now.

Section 19.3797 of Regulations 103, provides:

> "A trust may be classed as a trust or as an association. . . . It (association) includes any *organization*, created for the transaction of designated affairs . . . and the affairs of which, like corporate affairs, are conducted by a *single individual*, a *committee*, a *board* or *some other group*, acting in a representative capacity. . . . As distinguished from the ordinary trust described in the preceding paragraph there is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of *beneficiaries*. . . . The nature and purpose of a *cooperative undertaking* will differentiate it from an ordinary trust. . . . If a trust is an undertaking or arrangement conducted for income or

profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the *beneficiaries* are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Internal Revenue Code as a corporation. However, the fact that the capital or property of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association."

Note, please, the Commissioner declares "the *beneficiaries* are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association". In other words, those who are beneficiaries of the trust are the members of the association.

In *McKean v. Scofield* (1940), 108 F. (2d) 764, a father and four children owned oil and other properties as cotenants. On the same day, each of the five, by separate deed, conveyed to the father and two sons, as trustees, his interest in the oil properties, and by another deed his interest in the other properties, making ten conveyances and ten trusts. Each trust was created for the benefit of the grantor and his descendants. The trusts were substantially identical and the trustees had powers of full management and control, sale, lease, investment, reinvestment and partition. The trusts created by the children were to terminate five years after the death of the father. In administering the trusts, the trustees kept one bank account and one set of books. A tax was assessed on the

theory that all trusts constituted an association. The Circuit Court for the 5th circuit held there was nothing in law or the trust declarations that bound the trusts together, hence there was no association. The Court said:

> "It may be conceded that these trustees are engaged in business, so that if the owners in common had conveyed their interests into one trust, or otherwise formed a company to own and manage them, a business association might have resulted. They may have thought and purposed that a harmonious cooperation would be achieved by selecting the same trustees and giving them the same powers. But we think that so long as each owner kept his interest separate, and for the use of his own chosen beneficiaries, with no compulsory cooperation with the others, there arose among the several trusts nothing so like a corporation that it could be held an association taxable as a corporation."

There, the Circuit Court cited approvingly *U. S. Trust Co. v. Commissioner,* 296 U. S. 481, which was decided less than a month after the decisions in the famed *Morrissey* and companion cases were handed down. In the *U. S. Trust Company* case it was held that, by amendment, a trust had been converted into three trusts, each of which was taxable separately. It is interesting to note that in the *McKean* case, *supra,* there were ten trusts, and each trust had three trustees and one beneficiary, which was the factual situation in the Lombard Trust until March 14, 1937. If respondent's contention be correct that petitioner was an association while Dr. Lombard was the sole beneficiary, there would have been ten associations in the *McKean* case, and under the contention of the Collector

there, these ten associations would have constituted still another association.

Likewise, in *Magoon Trust Estate* (July 10, 1942), B. T. A. Memo No. 101503, the Commissioner unsuccessfully contended that two trusts, with common trustees, constituted an association taxable as a corporation.

In passing, we direct attention to the fact there is absolutely nothing in *Solomon v. Commissioner*, 89 F. (2d) 569, that intimates or holds there may be an association when there is only one person having a beneficial interest. In that case, there was created a trust under the Georgia law, which law provided for the issuance of certificates that "shall pass and be transferred as personalty and in the same manner as shares of stock in corporations; and the same shall be subject to levy and sale under attachment or execution or any other process, in like manner as shares of stock".

The declaration by which that trust was created provided that 1100 certificates should be issued to the grantor who in the same instrument transferred 1,000 of these certificates to the same trustees upon separate trusts for her 9 children and 2 grandchildren. These children and grandchildren immediately became beneficially interested. As each child's interest was held in trust for him, he was represented in the association by his trustees. Therefore, legally, there were as many associates as there were trusts for the children, plus one, representing the grantor. It was with respect to this situation that this court said: "It has been rightly determined to be an association, the grantor and five trustees who initially took title to the entire 1100 beneficial shares being the original associates." It was not claimed or held in that case that a subsidiary

trust with five trustees and one beneficiary constituted an association.

Respondent may contend that Dr. Lombard intended to form an association when the trust declaration was executed and hence, the trust should be deemed to have been an association from the first step. It may be conceded that at the time the trust declaration was executed in November, 1935, Dr. Lombard did intend or propose that *ultimately* the beneficial interest under the trust would be held by the members of his family and himself. Nevertheless, he did not intend them to be associated with him *at that time* for he himself retained the entire beneficial interest and he continued to keep and own such beneficial interest until March 14, 1935. He may not have understood the legal effect of all acts with respect to taxation, but he did knowingly take for himself and hold all beneficial interest until March 14, 1937, and during all of such times as he was free to carry out his intentions or to change or abandon them, and if he had died, all of the trust property would have been included in his tax estate. If the courts are to supply the legal effect of his associating others on March 14, 1937, the courts must also supply the legal effect of his conscious act of retaining to himself the full beneficial interest in the trust created by him.

In law, intent, unaccompanied by act, is never recognized, otherwise, as has been remarked, all of us would be criminals. Nor is mere intent recognized in the special field of tax law.

If it be contended that the acts of March, 1937, should be deemed to relate back to those of November, 1935, then what of the execution in September, 1938, of an amended declaration of trust, which the Board confesses "follows

more closely the form of a traditional trust" [T 70], and which was, in fact, a "traditional trust", taxable as a trust, if it be possible to make one? The evidence is clear there was no change of intention, and the 1938 amendment expressed what Dr. Lombard intended at the beginning. If the act in March, 1937, is to be made retroactive, let us be consistent and make the act of September, 1938, also retroactive, and having done that, all questions are answered and the trust from the beginning was the "traditional trust".

All Income From the Trust Property Prior to March 14, 1937, Was Returnable by and Taxable to Dr. Lombard.

Sec. 166 of the Revenue Act of 1936 reads:

> "Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested
>
> "(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or
>
> "(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor."

Article 166-1 of Regulations 94 provides in part:

> "(a) If the grantor of a trust is regarded, within the meaning of the Act, as remaining in substance the owner of the corpus thereof, the income therefrom is not taxable in accordance with the provisions of

sections 161, 162 and 163, but remains attributable and taxable to the grantor. . . .

"(b) Section 166 defines with particularity instances in which the grantor is regarded as in substance the owner of the corpus by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this article the grantor is deemed to have retained such power if he, or any person not having a substantial interest in the corpus or the income therefrom adverse to the grantor, or both, may cause the title to the corpus to revest in the grantor. If the title to the corpus will revest in the grantor upon the exercise of such power, the income of the trust is attributed and taxable to the grantor regardless of—

"(1) Whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to *alter* or *amend*, or to appoint; . . .

"(4) Whether the power to revest in the grantor title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both. A *bare legal interest, such as that of a trustee, is never substantial and never adverse.*

* * * * * * * * *

"(d) If the grantor is regarded as remaining in substance the owner of the corpus the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created."

Except for changing the term "Act" to "Internal Revenue Code", the corresponding article under regulations 103 reads as above.

The history of income from revocable trusts is reviewed in the recent case of *Welsh v. Bradley,* July 24, 1942, C. C. A. 1, No. 3772. It is there shown that as early as 1916, Congress provided for taxing trust income to the trustees, but the Treasury promptly ruled that the statute applied only when a trust was "irrevocable by the donor, otherwise the income from the property in question will accrue to the donor and must be accounted for by him"; and the 1918 regulations provided, "The income of a revocable trust must be included in the gross income of the grantor."

The Court in *Welsh v. Bradley, supra,* says:

> "In 1924 Congress expressly enacted the earlier Treasury practice of treating revocable trusts as an exception to the general provisions applicable to the taxation of income of trust estates. . . .
>
> "On the face of §219 (g) of the 1924 Act, it might be considered that there was an ambiguity in the provision that in the case of revocable trusts, 'the income' of the trust 'shall be included in computing the net income of the grantor'. Did Congress mean by 'the income' of the trust (1) the taxable net income of the trust, computed on the basis of considering the trust a separate entity, or (2) the gross income derived from the trust property determined by the criteria of the tax laws as if the trust had not been created? From the very beginning the Treasury has adopted the second interpretation, consistent with its earlier rulings before Congress had dealt specifically with revocable trusts.
>
> "This interpretation has been consistently adhered to under corresponding sections of the succeeding revenue acts."

The Court held valid the regulation under section 166 hereinbefore quoted requiring the gross income from the trust property to be included in the gross income of the grantor.

For three separate and distinct reasons, hereinafter mentioned, said section 166 of the Revenue Act of 1936 required the income from the trust property prior to March 14, 1937, to be returned directly by Dr. Lombard.

(a) Dr. Lombard and the other trustees (who did not have substantial adverse interests) had power to revest in Dr. Lombard parts, up to the whole, of the corpus by merely distributing it to him without any modification of the trust indenture. (The requirement of the statute would have been satisfied had there been power to revest only *part*.)

Article 9 of the trust indenture provided that "all income and estate funds" might be invested or distributed in the discretion of the trustees. [T 30.] By Article 17, the trustees were empowered at any time to make partial distributions, and upon termination of the trust, to distribute the residue, all distributions to be apportioned to the beneficiaries. [T 34.] By Article 18, the duration of the trust and its termination were committed to "the discretion of the Trustees". [T 34.]

Therefore at any time prior to March 14, 1937, the entire corpus and accumulated income might have been distributed to Dr. Lombard as sole beneficiary.

(b) Dr. Lombard and the other trustees (who did not have substantial adverse interests) had power to alter or amend the trust declaration so as to restore all or part of the corpus to Dr. Lombard.

In Article 22 of the trust declaration it was provided that the trust declaration might "be altered and/or amended at any time by the Full Membership of the then acting Board of Trustees".

(c) The trust was a revocable trust under California law and might have been revoked at any time by its grantor, Dr. Lombard.

Prior to its amendment in 1931, Section 2280 of the California Civil Code read:

> "A trust cannot be revoked by the trustor after its acceptance, actual or presumed, by the trustee and beneficiaries, except by the consent of all the beneficiaries, unless the declaration reserves a power of revocation to the trustor, and in that case the power must be strictly pursued."

This was the prevailing rule, namely, that a trust was irrevocable in the absence of a reserved power to revoke. (65 C. J. 340.)

In 1931, the code section was amended to provide

> "unless expressly made irrevocable by the instrument creating the trust, every voluntary trust shall be revocable by the trustor by writing filed with the trustee. When a voluntary trust is revoked by the trustor, the trustee shall transfer to the trustor its full title to the trust estate."

Article 21 of the trust declaration reads in full [T 35-36]:

> "Art. 21. Amendments: While Conveyance and Delivery of Properties herein described and referred to is Irrevocable, should any part or portion of these articles of covenant, whatsoever, be construed by any

Court to be contrary to or in contravention of law, it is the purpose and intention of all parties hereto. that in so far as this Conveyance and Contract is legal it shall continue in full force and effect and the Trustees shall operate thereunder. These Articles of Covenant for formal administration may be altered and/or amended at any time by the Full Membership of the then acting Board of Trustees jointly executing and attaching an appendix hereto, a copy of which with due reference hereto should be recorded in public records wherever this original instrument was previously recorded."

The article is entitled "amendments", and it specifically deals with and provides for two important matters. one, that void provisions shall not affect the validity of remaining provisions, and two, that the trustees may amend. It also contains an adverb clause reading: "While conveyance and delivery of properties herein described and referred to is irrevocable." That clearly is an assumption or recital. If this trust had been created prior to the 1931 amendment, the trust would have been irrevocable as a matter of law and the recital would have been clearly appropriate. It would also have been appropriate in those states following the general rule of irrevocability.

Under the present law, for a trust to be irrevocable, it must expressly be made irrevocable by the trust declaration. If the clause would have been a mere recital of a fact under the former law, how may it be held under the present law to be an express surrender of the right of revocation that the law preserves? It might be contended

the recital implies that the grantor intended to make the trust irrevocable. But the law preserves the right of revocation against mere implications in requiring an express surrender.

Explanation for the meaningless statement must be found in the fact we are dealing with a copyrighted form intended for use anywhere, and it is fairly evident the draftsman assumed the general rule as to irrevocability without regard to the special laws of California.

But apart from the foregoing consideration, when the settlor is the sole beneficiary, he may revoke the trust without the consent of the trustee even though the instrument expressly states that it is irrevocable. (65 C. J. 343.) Under the former law, the trust would have been irrevocable when others than the creator of the trust were beneficiaries; but under such law, while Dr. Lombard *as creator* was the sole beneficiary, he could have revoked it. There is nothing in the new law that prevents revocation when the grantor is also the sole beneficiary.

A trustee does not have a substantial adverse interest. (*Reinecke v. Smith*, 289 U. S. 172; *Greenough v. Commissioner* (1934—C. C. A. 1), 74 F. (2d) 25; *Morton v. Commissioner* (1940—C. C. A. 7), 109 Fed. (2d) 47.)

Where a grantor has the right to amend or revoke with the consent of any two of the trustees, the income is taxable to the grantor as the trustee does not have an adverse interest. (*Wetherbee v. Commissioner* (1934—C. C. A. 2), 70 F. (2d) 696.) A father, trustee of a family trust, is not a person having a substantial adverse interest. (*Loeb v. Commissioner* (1940—C. C. A. 2), 113 F. (2d) 664.)

Dr. Lombard Could Not Make His Gift Retroactive to February 10, 1937, so as to Relieve Himself From Returning Income Accrued to March 14, 1937.

On November 25, 1940, the U. S. Supreme Court rendered two decisions holding that one who is entitled to receive income at a future date and who makes a gift of it realizes taxable income, as much as if he had collected it and paid it to the object of his bounty.

In *Helvering v. Horst*, 311 U. S. 112, it was held that interest coupons given away prior to their maturity were taxable as income to the donor on a cash basis.

In *Helvering v. Eubank*, 311 U. S. 122, it was held that renewal insurance commissions after termination of the agency contract, voluntarily transferred by the ex-agent, were taxable as income to the agent when received by the transferee.

The cases mentioned were followed on March 31, 1941, by *Harrison v. Schaffner*, 312 U. S. 579, where a life beneficiary of income from a trust assigned to children specified amounts out of income of the following year. It was held such assignment did not relieve the assignor from tax on the income assigned.

In *Duran v. Commissioner*, BTA Memo., No. 98027, it appeared that on January 1, 1922, an insurance agent, by virtue of 20 years service, became entitled to an annuity for life provided he did not enter the service of another agent irrevocably assigned to his sister his right to receive the annuity payments. Held, that the power to dispose of income is equivalent to ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and, hence, the realization of the

income by him who exercises it. The annuity payments to the sister were taxable to the assignor.

The identical point here involved was passed upon in *Rose L. Ray*, BTA Memo, No. 101, 315, June 26, 1941. In the *Ray* case a husband and wife created trusts for the benefit of three children, the corpus consisting of oil and gas leases that were producing income. The trust instruments were prepared before November 1, 1935. They recited they were effective as of that date and the grantors reserved all income from the property prior thereto. The trust corpus was formerly owned by a partnership. The partnership books were closed as of November 1st, 1935, new books were started and from November 1, 1935, the income was distributed on the books according to the rights of the beneficiaries. Gift tax returns covering the trust property were filed. The property was valued for gift tax by a revenue agent as of November 1, 1935 and the case insurance company. Prior to the taxable year 1934, the closed. However, the trust declarations and conveyances were not actually executed until December 23, 1935. It was held that all income accruing prior to December 23, 1935, was taxable to the grantors, notwithstanding the trustees were entitled to the income from November 1, 1935.

In the instant case there was payable to the trustees on March 14, 1937 the sum of $1,868.96 as the balance of the sale price of the crop of oranges sold February 23, 1937. This was received on April 15, 1937. The full amount of this item of $1,868.96 was *net* income as the purchaser picked and hauled the fruit and the trustees neither incurred nor paid any expense in connection with the crop after its sale on February 23, 1937. [T 14.]

If petitioner became an association on March 14, 1937, the legal effect was as though, on that date, a trust, of which Dr. Lombard was sole beneficiary, transferred to an association created on that date, the right to receive this item of income. But under the cases, such transfer would not relieve the transferror from accounting for the income. However, under the statute, the income was that of Dr. Lombard's for tax purposes. Dr. Lombard could not escape liability because the transfer was made by the trustees rather than by himself. If such item of $1,-868.96 is to be included in Dr. Lombard's income, it follows that it is to be excluded from petitioner's income for the period March 14, 1937 to December 31, 1937.

The Ultimate Findings or Conclusion of the Board Are Not Supported by the Evidence.

In the findings, after reciting stipulated and admitted matters, the Board concluded [T 65]:

> "A trust at law was not created by Dr. Lombard by his execution on November 3, 1935, of the several instruments constituting the Hulbert Plan, and petitioner was not a trust prior to or during the taxable year. Rather, some type of enterprise in the nature of a family corporation was created under the Hulbert Plan. Dr. Lombard transferred absolute title, legal and equitable, to various properties, real and personal, to himself, Norman Lombard and Bertha Lombard, as joint tenants. They, and they only, were the equitable as well as the legal owners of the property. They and their successors only, could determine who should eventually receive distribution of the property upon liquidation of the enterprise. During the taxable year, 1937, petitioner was an association within the meaning of Section 1001 of the Revenue Act of 1936."

The foregoing is manifestly a conclusion of law and not a finding. Assuming it to be a finding of ultimate facts, it is without support in the evidence.

The opinion reveals close examination of details. The details of the Hulbert Plan are so vague, weird and unusual that one may be pardoned, who, contrary to the precept requiring substance to control form, becomes enmeshed and confused in details, attributing verity to statements that thoughtful consideration would show to be erroneous.

In the opinion it is said, in effect, that a trust was not created by the trust declaration for the reason the trustees became the legal and equitable owners of the property and the trust declaration did not name any beneficiary or *cestui que trust.* [T 65.] Article 15 of the conveyance and contract expressly required initial registration of the "expectancy fractions" to be according to instructions "delivered to the Board by Norman M. Lombard". [T 32.] Such instructions were delivered, and it was stipulated "said conveyance and contract and said instructions as to beneficaries *were executed as a part of and to evidence a single transaction and agreement*". [T. 9.]

An agreement may be expressed in several writings. This is true of trusts. At 65 C. J. 275, it is written:

> "A trust may be declared by means of several writings. The writings need not be contemporaneous nor *inter partes.* Contemporaneous instruments may be a sufficient declaration of trust, if when construed together, they show the intent to create a trust."

In this instance the instructions to register all expectancy fractions in Dr. Lombard was as much a part of

the trust declaration as the conveyance and contract. The holder of the expectancy fractions was entitled to all distributions, whether interim or final. Therefore, a beneficiary or *cestui que trust* was not only provided for but was distinctly named in the trust declaration. There was no justification for or merit in the statement in the opinion, "There was no conveyance to trustees in trust for named or personal beneficiaries as is typical of the traditional trust. The 'beneficiaries' were only impersonal registrants holding units of interest in earnings and proceeds." [T 68.]

The method used to name the beneficiary was unusual but that does not militate against the fact that a beneficiary was provided for and named in the trust declaration.

In the findings (or conclusion) hereinbefore quoted, it was declared that Dr. Lombard transferred "*absolute* title, legal and equitable" to persons who "were the equitable as well as the legal owners of the property" and who "could determine who should eventually receive distributions". [T 65.] Again, "Dr. Lombard conveyed the complete legal and equitable title to property." [T 68.]

There seems in the opinion to be a thought that the trustees acquired an interest or right greater than trustees of a strict trust acquire. At 65 C. J. 526, it is said:

> "Where the use is executed, the trustee takes no estate or interest; but where the use is valid and not executed, he is vested with the legal title, and at law the legal estate in the trustee possesses the same properties, characteristics and incidents as if he were the absolute owner, but there is authority which terms the trustee as merely a depositary of the legal title, and his estate but a power that may be exer-

cised. Some statutes provide that the trustee shall take both the legal and equitable title and the beneficiary only the right to enforce the performance of the trust, and under such or similar statutes the trustee is vested with the whole estate, subject to the execution of the trust."

Section 863 of the California Civil Code provides:

> "Except as hereinafter otherwise provided, every express trust in real property, valid as such in its creation, vests the whole estate in the trustees, subject only to the execution of the trust. The beneficiaries take no estate or interest in the property, but may enforce the performance of the trust."

The rule that a trustee takes the legal and equitable title or the "whole estate" applies to the *quantum* of estate taken. A trustee takes only the *quantum* that is necessary for the execution of the trust. Thus, one may purport to convey to a trustee fee title absolute, but if a life estate is all that is required for the execution of the trust, the trustee would take only a life estate, but in such life estate he would have the legal and equitable title. The rule is well stated in the following quotation from *Hunt v. Lawton*, 76 Cal. App. 655 (245 Pac. 803):

> "In *Morffew v. San Francisco & S. R. R. Co.*, 107 Cal. 587 (40 Pac. 810), the court had under consideration the *quantum* of estate taken under a decree of distribution by a trustee, to whom lands were distributed for the term of her natural life, in trust, to apply the income for the support and education of certain children. The court said: 'But the quantity of interest which passes to the trustee in case of an express trust is commensurate with the necessities of his office; the trustee shall have an estate in fee,

if that is necessary, to enable him to perform the duties imposed upon him, although it is not in terms given to him by the instrument creating the trust; on this principle a devise of lands in trust to sell clothes the trustee with the fee, because necessary to the execution of the trust. The rule being compendiously stated that the trustee "will take an estate adequate to the execution of the trust—no more or less". *Perry on Trusts*, sec. 320, *Young v. Bradley,* 101 U. S. 787 (25 L. Ed. 1044).)'

"In general, whatever the language by which the trust estate is vested in the trustee, its nature and duration are governed by the requirements of the trust, and in equity the extent and quality of the trustee's estate is commensurate with, and dependent largely upon, the purposes of the trust and the duties imposed thereby on the trustee as expressed in the terms of the instrument creating the trust; the trustee takes exactly that quantity of interest, whatever it be, which the proper execution of the trust may require, and no more, and even though granted to the trustee to the fullest extent, the legal estate will not be carried further than the trust requires."—65 C. J. 527-529.

The trust declaration did provide for a beneficiary. On November 3, 1935, property was conveyed to others for the benefit of Dr. Lombard. That created what is known as a trust. Whether it was to be classified for taxation as a strict trust is beside the question at this point. The principles under consideration apply as much to a trust that will be taxed as an association as to one that will be taxed as a trust. Therefore, the trustees took such *quantum* as was necessary to the execution of the trust. As they were given power to sell and convey, in fee, they

necessarily took a fee. And they took, as trustees, the legal and equitable title in fee.

There seems, in the opinion, a pronounced thought that when a trust is to be classified as an association for taxation, the general principles applicable to trusts no longer apply. Nothing could be more wrong.

The mumbo jumbo in the trust declaration such as "said trustees become sole owners of an estate with no restraints on powers of alienation" [T 20] and "they (trustees) are hereby made, in fact, absolute and exclusive owners" probably impressed and awed the suckers who purchased and used it, but is absolutely meaningless to a lawyer.

In the opinion it is said that Dr. Lombard (on November 3, 1935) created "some type of enterprise in the nature of a family corporation". [T 65.] The term "family corporation" is loosely used to indicate a situation where members of a family own at least a majority of stock of a corporation and thereby control it. The term does not have reference to the directors, but to the stockholders. The directors might be, and frequently are, bookkeepers, secretaries or others in the employ of the corporation or the stockholders. At least they are responsive to the stockholders. The term "family corporation" is not used to apply to one who owns all of the stock of a corporation. Now, if Dr. Lombard had formed a corporation and taken all of its stock, he would not, nor would the corporation, have been referred to as a "family corporation". Therefore, any suggestion that in 1935 Dr. Lombard formed something in the nature "of a family corporation" is meaningless.

It is also said, "In form, petitioner resembles a 'Massachusetts trust'". [T 72.] The Board appears to have difficulty in classifying petitioner. Petitioner was not a corporation nor a partnership. If the tax laws might have been forgotten for a moment, the Board would have had no difficulty in labeling petitioner. Then the only question would have been, is petitioner a trust that is to be classified as an association for taxation? If the Board would refer to the discussions in the oft quoted Supreme Court cases, or to the opinion of this Court in the *Porter* case, or to the regulations, the Board would find that trusts classified for taxation as associations are still trusts under general laws and referred to as such. The Board approaches the question as though a new species of organization unknown to law, had been created. It incorrectly says that petitioner had no beneficiary or *cestui,* and, therefore, concludes petitioner could not be a trust.

The question is not so difficult as the Board makes it. A trust was created in November, 1935, of which Dr. Lombard was the sole beneficiary. No trust of which the grantor is the sole beneficiary has ever been held to be an association, nor can it be, for there must be a plurality of persons for whose benefit the enterprise is conducted before such an organization is to be classified as an association. Whether the association be in trust form or other form, there still must be more than one member or beneficiary to make the organization subject to taxation as an association. Until March 14, 1937, Dr. Lombard was the creator and sole beneficiary. As the organization could not under any circumstances be classified as an association prior to March 14, 1937, it might only be classified as a trust, but for reasons noted, it was not taxable as a trust. Rather, all income was returnable

directly by Dr. Lombard. The Commissioner was closer to being correct than his attorneys or the Board.

In the opinion it is said, "Thus, it appears that Dr. Lombard, his wife, and his eight children, became associates". [T 69.] That statement does not answer our point that prior to March 14, 1937, Dr. Lombard had no associates. While at places the opinion appears to recognize the legal necessity of more than one beneficiary before there may be an association, it ignores the fact that prior to March 14, 1937, Dr. Lombard had no associates. The opinion just does not meet and answer the point.

In the opinion emphasis is given to the fact that the trust had rental properties, raised oranges and had substantial receipts. [T 71.] From this is the deduction that the trust is a business enterprise. The deduction is unwarranted. In the trust are the properties conveyed to the trustees by Dr. Lombard. Had the trust been the strictest of strict trusts, would not the trustees have collected the rents and produced fruit on the orchard? The activities of the trustees in this particular are no evidence that the trust was formed for a business purpose or that it was not.

It does appear, however, that during the 4 years and 3 months that elapsed between March 14, 1937 and the hearing, the trustees made only two sales apart from ranch products, and sold only one small block of stock and one small block of bonds. [T 15.] This is some evidence of inactivity and lack of profit purpose. It shows that the trustees were engaging only in the business of managing the properties received from Dr. Lombard. The Board fails to note such inactivity and its significance, while drawing an unwarranted inference from the fact that the trustees managed the property received from Dr. Lombard.

The Board Erred in Refusing or Failing to Consider Evidence of Purpose.

In *Porter Property Trustees, Ltd., supra,* this Court said:

> "There are two tests to be applied to a trust in order to determine whether or not it is taxable as a corporation: (1) what is its purpose?; and (2) what is the extent of its business activity? Of the two, the first is the more important."

The second point respecting activity was hereinbefore commented upon. As noted, the activities have been confined to managing the property received from Dr. Lombard. The trustees did not engage in drilling oil wells or in subdividing and selling lands. They did not engage in buying and selling securities. Only one change in the securities was made. They could not have done less had this been a strict trust in the four years and three months elapsing after March 14, 1937. On March 24, 1937, the trustees sold stock of American Trust Company for $5,145.35 and bought stock of Baltimore American Insurance Company for $5,133.75. [T 15.] If the business activities of the Lombard Trustees have any evidentiary value, they show the purpose of the trust was to manage and conserve property for the benefit of Dr. Lombard, Mrs. Lombard and their children.

In trusts, purposes and powers are often confused. Most strict trusts confer broad powers upon the trustees. In "Forms of Wills and Trusts distributed exclusively to attorneys-at-law by the trust department of Security-First National Bank of Los Angeles, Los Angeles, California, Fourth Edition, 1941", about 650 words are used to state *additional* powers in a form of testamentary trust. The

writer confesses to having drafted innumerable wills with trusts in which nearly three legal-size pages were required to enumerate the *additional* powers. Powers do not provide a criterion for determining whether a trust is to be classified for taxation as a strict trust or an association, and it is necessary to avoid the conclusion that the purpose of a trust must be thus and so as the trustees have power to do that.

To determine purpose, first look to the trust declaration. If the purpose is there stated or apparent, that will and should control. When the Supreme Court, in *Helvering v. Coleman-Gilbert Associates*, 296 U. S. 369, said "Weight should be given to the purpose for which the trust was organized, but that purpose is found in the agreement of the parties", it did not insert "written" before agreement. Manifestly, when people "associate" so as to form an "association", there must be some agreement. It might be wholly written, or wholly in parole, or in part each. If the written agreement is in writing and states the purpose of the association, then, says the Supreme Court. "the parties are not at liberty to say that their purpose was other or narrower than that which they *formally set forth* in the instrument under which their activities were conducted". The observations of the Supreme Court are sometimes misapplied.

In the trust declaration there is no statement of purpose. It does not state the purpose was to liquidate Dr. Lombard's property and distribute the avails, nor does it state the purpose was not to liquidate and distribute, but there is *power* to liquidate and distribute. It does not state the purpose was to hold and manage property for the benefit of Dr. Lombard's family and distribute the income to

them, nor does it show the purpose was not to do that, but there is power to do it. It does not state the purpose was to buy and sell property for profit, but there is power to do so. Hold the instrument by the four corners and its purpose does not appear. One can make conjectures. but he does not know what purpose Dr. Lombard had in mind in executing it or in transferring interests to the others.

Dr. Lombard testified to his purpose.

First, he wanted to relieve himself of responsibility. He was 83 years old. He wanted leisure to travel and he and his wife did travel abroad extensively after establishing the trust. [T 17-19.] That was not a business purpose. That was not a case of people associating themselves with a business motive. to make money by drilling for oil, subdividing lands, buying and selling, or conducting any of the numerous activities for which people associate for profit.

Secondly, he expected his wife, who was 19 years and 4 months younger, to survive him and he desired to provide her with an income for her support as long as she lived. [T 17.] (Note, that in the transfer and re-registration of March 14, 1937, 350 "expectancy fractions" were placed in the name of Dr. Lombard and Mrs. Lombard as joint tenants. [T 41.]) Again, this was not a business purpose. It is not a purpose out of which associations are formed. It is the identical purpose for which innumerable strict trusts are established, namely, to provide for the support of the widow of the grantor.

Finally, after he was gone, Dr. Lombard wanted the children to be able to sell the various properties and divide

the proceeds from time to time as the market justified. [T 17.] This was not a business purpose that induces people to associate for profit.

On September 30, 1938, the trust declaration was amended. [T 11.] The notice of deficiency was not mailed until June 15, 1940, more than 1 year and 8 months after the amendment. As amended, the trust was made irrevocable, the net income was made distributable annually to Dr. Lombard, Mrs. Lombard and the eight children and their issue, the beneficial interests were made incapable of alienation and authority was conferred to distribute cash or property in kind to those entitled to income. [T 44-52.] If it be possible to create an ancestral trust, the amended declaration does that.

What has been done by the parties after establishment of the trust has been reviewed and referred to in practically every decision as evidence of their purpose. In no case was there any act or thing as significant and persuasive as this solemn and formal writing. In the opinion it is written, "Petitioner asks us to go outside the terms of the agreement which was in effect in the taxable year for the purpose. This we cannot do." [T 70.] The statement is erroneous.

In the brief filed with the Board, appellant wrote:

> "In determining purpose, the acts of the parties after establishment of the trust are properly and usually referred to. Such appears in nearly every decision including that in the Porter case. The execution of the new trust declaration was an act of the parties interested in the trust involved in this case, and that act is understandable and relevant. The necessity for making certain the provisions of the

> trust attempted to be stated in the first declaration and resolving questions of its validity are apparent to one having a superficial knowledge of trusts and conveyancing. The provisions of the new trust declaration are harmonious with those of the first trust declaration in so far as those of the first are possible of understanding.
>
> "Not only are *acts* of the parties relevant in determining the purpose for which a trust was created, but, manifestly, their declarations are relevant. The new trust declaration contains the solemn declaration and agreement of all the interested parties as to their purpose. It would be difficult to find any better or more persuasive evidence of purpose than the new trust declaration, affecting, as it did, valuable property rights."

From the statement of the Board, it is apparent the Board deemed it could not consider this amended declaration to determine that which had to be determined, namely, the purpose of the parties. Nor did it give any consideration to the testimony of Dr. Lombard except as hereinafter noted.

The Board said,

> "The general purpose stated in the 'Plan', the broad powers given to petitioner, the facts as to petitioner's activities, all lead to the conclusion, *in the absence of contradictory evidence*, that the purpose was to provide a method of putting all of Dr. Lombard's business properties under centralized and continuous management for realizing profits and distributing them to all who came into the plan." [T 71.]

There is no general purpose stated in the trust declaration, nor is there a specific purpose. For aught that appears in the trust declaration, Dr. Lombard and his "associates" may have had a purpose to use the profits for sending missionaries to Japan. There is nothing in the trust declaration requiring "profits" to be distributed to the beneficiaries, and the suggestion that the purpose was to realize profits and distribute them to the beneficiaries is purely gratuitous. The Board uses the expression "in the absence of contradictory evidence". If the purpose appears in the trust declaration, there may be no contradictory evidence of purpose. Evidently the Board does not find in the trust declaration satisfactory evidence of purpose. At the same time, it refuses to consider the abundant evidence of purpose.

At page 69, the Board says, "Evidence in this case which negatives the creation of a trust and which indicates an association is found in the fact that Dr. Lombard set about to obtain the consent of eight of the children to come into the plan". Evidently, for some purposes, the Board does consider evidence. The evidence to which it refers is part of Dr. Lombard's testimony. It uses that evidence to establish the trust was an association. It says, "Purpose is important, if not determinative". [T 70.] Therefore, the Board uses some of Dr. Lombard's testimony to prove *purpose*, but it refuses to consider evidence that would establish a different purpose.

The Board refers to and uses the evidence of transfers of "expectancy fractions" in 1937 and 1938 to establish

that the purpose was to create an association, while at the same time it says it cannot consider the amended trust declaration to help it determine purpose.

The fact is the Board freely uses everything it finds to establish a business purpose and rejects and will not even consider stronger and more persuasive evidence of a different purpose. We are aware of the right of the Board to weigh evidence. But there is no dispute or conflict in the evidence. It is apparent the Board acted under a misapprehension as to the law.

In *Porter Property Trustees, Ltd.* there was no specific evidence of purpose. Had there been none in the instant case, the Porter case would have been decisive on the question that after Dr. Lombard associated others with him as beneficiaries, the trust was an association. However, there was in the instant case an abundance of evidence on the question of purpose and it is apparent it has not been weighed and that the Board did not decide the case on the evidence.

Respectfully submitted,

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